
Editorial

Fed Policy Encourages Margin Debt

BY BERT ELY

The Fed raised the federal funds rate target by .25 point on March 21, more to deflate the stock market than to cool the economy. The major stock indices, however, immediately jumped, heightening the impression that there is a bubble in at least certain sectors of the stock market.

To the extent there is a bubble, it can be attributed to rapid growth in margin debt. The FFRT, however, increases the attractiveness of using margin debt to make leveraged bets in the market, by reducing the risk of making those bets. Hence, the FFRT, the Fed's principal monetary policy tool, is part of the problem, not part of the solution.

The FFRT is a problem because it significantly distorts short-term interest rates on a daily basis by smoothing those rates over the short term, specifically between meetings of the Fed's Federal Open Market Committee. One effect of this rate smoothing is to increase an investor's certainty of the cost of using debt to finance stock market investments. If his stocks decline, the investor suffers a loss, but at least his financing cost remains fairly constant.

If short-term rates were as unpredictable and volatile from day to day as longer-term interest rates and commodity prices, investors would be much more cautious in making leveraged bets. Reduced margin borrowing would remove purchasing power from the stock market, which would trim stock prices to more realistic levels.

According to recent reports, margin loans climbed 8.9 percent in February among New York Stock Exchange member firms, to \$265 billion, following a 6.5 percent rise in January. Margin debt now accounts for 1.53 percent of total market capitalization, up from 1.34 percent at the end of 1999. And that is just the known margin debt. Hidden margin debt takes many forms, including what individual investors borrow against the equity in their homes and even on credit cards to invest in the market.

After growing 6 percent a year in 1996 and 1997, home mortgage debt grew \$370 billion, or 9.3 percent, in 1998 and more than \$400 billion last year, or about 10 percent. Some of those billions have gone into the market as we witness a phenomenon troublesomely similar to the 1980s when Japanese investors borrowed against highly inflated land values to invest in a grossly overvalued stock market. In Japan, like the United States today, short-term interest rates were quite predictable.

The FFRT has its greatest smoothing effect on the interest rates charged on margin debt. The prime rate, which is the interest rate against which many loans, including home equity loans, are priced floats rigidly at 3 percent above the FFRT. Many other private-sector borrowing rates also track the FFRT at fairly stable spreads.

For example, between Feb. 10 and March 10 of this year, the rate on commercial paper issued by financial firms for 2-month periods (slightly longer than the gap between FOMC meetings) varied over a range of .09 percent, or 9 basis points. Most days, this two-month rate, if it changed at all, varied by one or two basis points; the maximum change was 6 basis points. The 10-year Treasury note is a different story. For the same period, its yield varied over a 32-basis-point range, with daily swings of as much as 11 and 13 basis points.

Longer-term rates should be much more stable than short-term rates on a daily or even a monthly basis because inflationary and deflationary events in an economy (a jump in oil

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prices; a rise in the unemployment rate) reverse themselves within a few months or a few years at most. Over 10 years, or more, economic shocks fully neutralize themselves even though that is not the case over the short term. Hence, the interest rate on short-term debt instruments, such as commercial paper and margin loans, should vary sufficiently to offset fully the effect of economic events, which have not yet reversed themselves.

The FFRT's smoothing effect, however, shifts this interest rate volatility to the longer end of the yield curve, with two deleterious effects. First, longer-term rate volatility whipsaws those sectors of the economy, notably housing, that have the longest production lead times. Extremes in this whipsawing can trigger a recession or overheat the economy, which often leads to recession. Stabler longer-term rates would produce steadier economic growth, quarter to quarter, thereby continuing the United

States' record economic expansion.

The second harmful effect is the phenomenon discussed above — too predictable short term rates over the short-term. Unpredictable daily swings in short term rates of 25 to 50 basis points, or more, and even greater short-term rate movements over a few weeks or months, would certainly lessen the appeal of using borrowed funds to make stock market bets.

The alternatives frequently discussed for deflating the stock market fall into two categories—raise the FFRT or boost margin requirements. Both alternatives represent government meddling in the marketplace, which invariably is counterproductive. Further, margin requirements are easier than ever to evade.

There is a third alternative—abolish the FFRT. That is, the Fed would stop signaling what it thinks is an appropriate level of short-term interest rates. Instead, the financial markets should be relied upon to set all interest rates, just as they now set longer-term rates. After all, interest rates are just

another price, and markets are much better at setting prices than government agencies, which the Fed is.

Many persons, including otherwise believers in free markets, may be shocked at the idea of abandoning the Fed's short-term interest-rate guidance. However, they should be greatly troubled by the risk that the Fed's attempt to pop a stock market bubble could unnecessarily slow economic growth or even spark a recession.

Getting the Fed out of the rate-signaling business raises this question: What would the Fed then do, since the markets already determine the quantity of money? That interesting question lies beyond the scope of this article. However, that challenge does not justify the continuation of the Fed's short-term interest-rate signaling and the great harm that such signaling can cause the U.S. economy.

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